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TAX INFORMATION RELEASE NO. 2007-05

RE: Department of Taxation's Position on Qualified High Technology Business Status for Disregarded Entities.

The purpose of this Tax Information Release is to provide taxpayers and tax professionals with guidance on how the Department of Taxation (Department) analyzes whether activities for purposes of the Qualified High Technology Business (QHTB) "Activity Test," or gross income for purposes of the "Gross Income Test" are satisfied by a high technology business considered a disregarded entity. This Tax Information Release explains the general law relating to the characterization of disregarded entities for tax purposes and the Department's position.

GENERAL LAW RELATING TO CHARACTERIZATION OF DISREGARDED ENTITIES FOR TAX PURPOSES

As a conforming jurisdiction, Hawaii conforms to various federal administrative tax provisions contained in Subtitle F of the Internal Revenue Code. *See* HRS § 235-2.5(a). Through what are commonly known as the "check the box" regulations, the Internal Revenue Service allows businesses, other than a corporation, to elect the tax classification status of the entity. *See* Treas. Reg. § 301.7701-3(a). For example, an eligible business entity with at least two members may elect to be taxed as a partnership, corporation; or an eligible business entity with a single owner can elect to be treated as an association or a disregarded entity for tax purposes. *See* Treas. Reg. § 301.7701-3.

Hawaii conforms to the "check the box" regulations and will allow a business entity in Hawaii to elect its taxation as allowed under Treasury Regulation § 301.7701-3. As a general matter, a business, unless it otherwise elects, will be "disregarded as an entity separate from its owners if it has a single owner." *Id.* When an entity is considered a disregarded entity, it is considered such for Hawaii income tax purposes. *See generally* TIR 97-4. In limited circumstances, Treasury Regulations will ignore the disregarded entity status to ensure optimal compliance with the tax laws and consider the entity separate and distinct from its owners. *See* TD 9356 (August 15, 2007) ("[F]inal regulations under which qualified subchapter S subsidiaries and single-owner eligible entities that currently are disregarded as entities separate from their owners for Federal tax purposes will be treated as separate entities for employment tax and related reporting requirement purposes." *Id.*).

QUALIFIED HIGH TECHNOLOGY BUSINESS "ACTIVITY TEST" & "GROSS INCOME TEST"

Section 235-110.9, Hawaii Revised Statutes (HRS) provides a nonrefundable income tax credit up to \$2 million for an investor's investment in a QHTB over a five-year period. *See* HRS § 235-110.9(a). Section 235-110.91, HRS, provides a refundable income tax credit for QHTBs that perform qualified research in Hawaii as defined in Section 41(d) of the Internal Revenue Code. Section 235-110.91 uses the definition of QHTB in section HRS § 235-110.9.

In order to be considered a QHTB for purposes of the high tech investment and research & development income tax credits, the business must satisfy one of two tests. To be considered a QHTB the Company must employ or own capital or property, or maintain an office, in Hawaii and:

- (1) More than 50% of its total business activities must be qualified research and more than 75% of its qualified research must be conducted in Hawaii (the "Activity Test"); or
- (2) More than 75% of its gross income must be derived from qualified research and the income from this qualified research must be received from:
 - (a) Products sold from, manufactured, or produced in Hawaii; or
 - (b) Services performed in Hawaii (the "Gross Income Test").

HRS § 235-110.9(g).

A commonly formed entity that is typically disregarded for income tax purposes is a single-member limited liability company (SMLLC). The same analysis would apply to a qualified Subchapter S subsidiary (QSSS). When such entities are disregarded, the entity is considered merely an operating division of the owner-parent. The activities or gross income of the disregarded entity is wholly attributable to the parent-owner.

HRS § 235-110.9 "ACTIVITY TEST"

For purposes of the HRS § 235-110.9 "Activity Test," the general principle that disregarded entities are disregarded for income tax purposes can prevent an otherwise qualified business' activities from satisfying the "Activity Test" because all activity of the disregarded entity will have to be tested against all activity of the parent-owner. The "Activity Test" requires that at least 50% of a business' total business activity be in qualified research and that more than 75% of its qualified research must occur in Hawaii. If the SMLLC or QSSS is disregarded, all qualified research activity conducted in Hawaii will be determined by considering all activity of the parent-owner worldwide, which may be disqualified activity or occurring in places other than Hawaii. In this case, an otherwise qualified entity will be prohibited from qualifying as a QHTB; thus disqualifying the local entity from qualifying for any QHTB tax incentives.

HRS §235-110.9 "GROSS INCOME TEST"

For purposes of the HRS § 235-110.9 "Gross Income Test," the same analysis applies. The principle that disregarded entities are disregarded for income tax purposes can prevent an otherwise

qualifying business' gross income from satisfying the "Gross Income Test" because all gross income of the disregarded entity will be tested against all gross income of the parent-owner. The Hawaii SMLLC's or QSSS' gross income will be severely diluted when aggregated with the worldwide income of the parent-owner. In many instances, QHTBs shift from the "Activity Test" to the "Gross Income Test" after research and development has been completed and a product is commercialized. In order to maintain QHTB status for the five year mandate, Hawaii QHTBs rely on the "Gross Income Test" to qualify. If the local Hawaii SMLLC or QSSS that is a disregarded entity is disregarded for purposes of the "Gross Income Test," an otherwise qualified entity will be prohibited from qualifying as a QHTB in this instance, thus disqualifying the local entity from qualifying for any QHTB tax incentives.

"ACTIVITIES TEST" FOR PURPOSES OF HRS § 235-7.3

It is important to note that the definition of a QHTB for purposes of the High Technology Business Investment Tax Credit, HRS § 235-110.9, is materially different from the definition of a QHTB for purposes of HRS § 235-7.3. Under HRS § 235-7.3, certain royalty income owned by a QHTB is exempt from Hawaii income tax. Section 235-9.5, HRS, utilizes the same definition of QHTB under HRS § 235-7.3 to exempt stock options and other equity income from income taxation.

For purposes of HRS § 235-7.3, QHTB "means a business that conducts more than fifty per cent of its activities in qualified research." This section contains only an "activities" analysis and does not contain an "Activity Test" or "Gross Income Test," which is the case for the definition of QHTB under HRS § 235-110.9, discussed above. However, the same issue arises for disregarded entities in determining whether the activities satisfy the Sections 235-7.3 and 235-110.9.5 requirements.

DISREGARDED ENTITIES MAY HAVE THE OPTION OF ANALYZING QUALIFIED RESEARCH ACTIVITIES OR GROSS INCOME AT THE SUBSIDIARY-DIVISION LEVEL OF THE DISREGARDED ENTITY

For purposes of satisfying the HRS § 235-110.9 "Activity Test" or "Gross Income Test" or the "Activities Test" for purposes of HRS § 235-7.3, the Department will allow eligible entities that are considered disregarded entities for tax purposes under the "check the box" regulations to analyze the entity's activity or gross income at the level of the disregarded entity. An entity that is otherwise disregarded from its owner will be treated as separate and distinct from its owner for purposes of satisfying these three tests.

The Department will only allow a disregarded entity to be considered separate and distinct for purposes of satisfying the HRS § 235-110.9 "Activity Test" or "Gross Income Test," or the HRS § 235-7.3 "Activities Test." The taxpayer may not argue the separate status in the instance of this TIR as a basis for separate consideration in any other tax matter; except where otherwise allowed by law. (*See supra*, discussing separate consideration for employment taxes).

The Department is allowing taxpayers the option to test its activities at the level of the disregarded entity in order to avoid unintentional disqualification of otherwise qualified businesses. The purpose of the QHTB tax incentives is to encourage capital investments, research and development, and other high tech activity in Hawaii to build a robust technology industry. The effect

of the Department's position is to encourage larger companies with both qualified and unqualified research activities to establish qualified research operations in Hawaii to take advantage of the tax benefits available. Under this Tax Information Release, the qualified research activities are tested at the disregarded entity level.

EXAMPLE—BigTech, Inc. is a high technology software firm headquartered in Washington State. Its major business activity is the research and development of computer software. For purposes of this example, its software development activities would qualify as "qualified research" in the general sense, as defined in HRS § 235-7.3. BigTech, Inc. has 50 subsidiaries located throughout the world, all of which are single-member LLCs and considered disregarded for tax purposes. As such, BigTech, Inc. is able to consider each LLC as a separate operating division and can efficiently account for all economic activity as part of a single corporate tax filing. Simultaneously, each LLC provides BigTech, Inc. liability limitation, geographic licensing control over its intellectual property, and employment regulation. Moreover, each LLC has economic substance and business purpose because each LLC has its own employees, maintains a separate office, and has considerable contracts with unrelated third-parties. BigTech, Inc. would like to establish operations in Hawaii in order to further its research and development and its software business. Prior to this TIR, BigTech, Inc. may have been discouraged to establish operations in Hawaii because its prospects for tax incentives could have been eliminated because the research activities for purposes of the "Activity Test" would have taken into account each of the operating divisions' activity worldwide. Thus, BigTech, Inc.'s activities in Hawaii, when compared worldwide, would have likely been insufficient to meet the 75% qualified research component occurring in Hawaii.

Based upon this TIR, BigTech, Inc. will be allowed to analyze the "Activity Test," "Gross Income Test," or the HRS § 235-7.3 "Activities Test" at the level of the disregarded entity at the option of the taxpayer. BigTech, Inc. may now form LittleTech-Hawaii, LLC, a single member LLC and analyze LittleTech-Hawaii, LLC's activities under the relevant tests without including BigTech, Inc.'s activities. Assuming LittleTech-Hawaii, LLC's qualified research activities constitute sufficient activity or gross income in Hawaii, LittleTech-Hawaii, LLC may claim any relevant QHTB tax incentive, including the credits for investments in LittleTech-Hawaii, LLC under HRS § 235-110.9.

TESTING ACTIVITIES & INCOME AT THE DISREGARDED ENTITY LEVEL IS OPTIONAL

It is important for taxpayers and tax professionals to understand that electing to test the activities or gross income of a QHTB at the level of the disregarded entity is optional. In some instances, it may be more beneficial to companies in particular industries to have the disregarded entity's activities be attributed to the parent-owner. In instances where a business benefits from the disregarded entity status, taxpayers may continue to consider the entity as disregarded for purposes of the HRS § 235-110.9 "Activity Test" or "Gross Income Test," or the HRS §235-7.3 "Activities Test."

EXAMPLE—FilmCo., Inc. is a production company that films several films in Hawaii. For industry purposes, motion picture production companies form separate LLCs for each film being produced. This practice is industry standard, allows for streamlined securitization of intellectual property rights, provides limited liability during production of the various films, and hedges future infringement exposure to other films owned by the parent-owner, FilmCo, Inc. In order to qualify for various QHTB tax incentives, sufficient activities and gross income need to be generated at the FilmCo, Inc. level, while still maintaining the separate status of the various productions. In order to attribute sufficient activities over a five-year period, FilmCo., Inc. considers each of the various LLC/productions as disregarded entities, thus attributing the activity to FilmCo, Inc. as the parent-owner. Because all of the activities of the separate LLCs will be directly attributable to FilmCo, Inc., activities of FilmCo, Inc. and the various production subsidiaries can be considered towards satisfying the requirements for QHTB status under these facts.

CONCLUSION & EFFECTIVE DATE

The Department of Taxation intends this guidance to serve as an optional analysis that businesses may utilize for purposes of qualifying as a QHTB. Based upon this TIR, a taxpayer may test the business activities and gross income for purposes of the HRS § 235-110.9 "Activity Test" or "Gross Income Test," or the HRS § 235-7.3 "Activities Test" at the disregarded entity level in order to qualify as a QHTB. A taxpayer may also continue to disregard an entity if disregarding the entity for tax purposes qualifies the high tech company and its subsidiaries as a QHTB. This Tax Information Release takes effect immediately and is retroactive where consistent with the foregoing.

For more information on this Tax Information Release, please contact the Rules Office at (808) 587-1553.



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HRS Explained: 235-7.3; 235-9.5; 235-110.9; 235-110.91